

Case No. 12
FILED

UNITED STATES OF AMERICA

WILLIAM L. BROWN, JR. Petitioner,

Respondent.

Appeal from the Supreme Court of the State of Kentucky.

WILLIAM L. BROWN, JR.,
Respondent,
vs.
WILLIAM L. BROWN, JR.,
Petitioner.

WILLIAM L. BROWN, JR.,
Respondent,
vs.
WILLIAM L. BROWN, JR.,
Petitioner.

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QUESTION PRESENTED

Whether a state may, consistent with the Commerce Clause of the United States Constitution, levy an intangible property tax on ownership of shares of corporate stock where such tax is reduced in an amount directly related to the amount of income of the corporation issuing the stock which is allocated to and taxed in the state.

TABLE OF CONTENTS

	PAGE
TABLE OF AUTHORITIES	i
INTEREST OF THE AMICUS CURIAE	1- 3
SUMMARY OF ARGUMENT	3- 5
ARGUMENT —The North Carolina Supreme Court Correctly Ruled That the Tax on Corporate Stock Does Not Violate the Commerce Clause	5-20
A. Fulton Corporation's Commerce Clause Challenge Is Controlled by <i>Darnell v. Indiana</i>	5- 8
B. The North Carolina Tax Scheme on Shares of Stock Is Not Facially Discriminatory	8-11
C. The Important State Interest to Avoid Double Taxation Underlies the North Carolina Shares Tax Scheme, and Any Indirect Burden on Interstate Commerce Does Not Exceed the Local Benefits	12-14
D. The North Carolina Shares Tax Scheme Is Internally Consistent	14-15
E. The North Carolina Shares Tax Scheme Is Compensatory in Nature and Thus Should be Upheld as Constitutional	15-19
CONCLUSION	20
APPENDIX	

TABLE OF AUTHORITIES

	PAGE
Cases:	
<i>St. Ledger v. Commonwealth of Kentucky</i> , 94-SC-875-D & 94-SC-468-DG	2
<i>Darnell v. Indiana</i> , 226 U.S. 390 (1912)	passim
<i>Klein v. Jefferson County Bd. of Tax Supr's</i> , 230 Ky. 182, 18 S.W.2d 1009 (1929) <i>aff'd</i> 282 U.S. 19 (1930)	3, 19
<i>Kidd v. Alabama</i> , 188 U.S. 730 (1903)	3, 6-7
<i>Maryland v. Louisiana</i> , 451 U.S. 725, 754 (1981)	4, 9, 11, 12
<i>Virginia v. Imperial Coal Sales Co.</i> , 293 U.S. 15 (1934)	4, 12
<i>Oregon Waste Systems, Inc. v. Dept. of Environmental Quality</i> , 511 U.S. 128 L.Ed.2d (1994)	5, 8, 15
<i>Fulton Corp. v. Justus</i> , 338 N.C. 472, 450 S.E.2d 728, 729 (N.C. 1994), <i>cert. granted</i> <i>sub nom. Fulton Corp. v. Faulkner</i> , 131 L.Ed.2d 554 (1995)	6, 7, 17, 19
<i>Darnell v. State of Indiana</i> , 174 Ind. 143, 90 N.E. 769, 774 (1910) <i>aff'd</i> , 226 U.S. 390 (1912)	6, 14
<i>Wright v. Louisville & N. R. Co.</i> , 195 U.S. 219, 222 (1904)	7
<i>Indiana Dept. of State Revenue v. Felix</i> , 571 N.E. 2d 287 (Ind. 1991), <i>cert. dismissed</i> , 502 U.S. 1084, 117 L.Ed.2d 278 (1992)	7, 14
<i>American Trucking Assns. v. Smith</i> , 496 U.S. 167, 180 (1990)	8
<i>Oklahoma Tax Commission v. Jefferson Lines, Inc.</i> , 514 U.S. ___, 131 L.Ed.2d 261 (1995)	8, 9
<i>Norton Co. v. Dept. of Revenue</i> , 340 U.S. 534 (1951)	8
<i>United States v. Salerno</i> , 481 U.S. 739, 745 (1987)	8
<i>New Energy Co. of Indiana v. Limbach</i> , 486 U.S. 269, 273 (1988)	9
<i>Commonwealth Edison Co. v. Montana</i> , 453 U.S. 609, <i>reh'g den.</i> , 453 U.S. 927 (1981)	9
<i>Boston Stock Exchange v. State Tax Comm'n.</i> , 429 U.S. 318 (1977)	9, 10

<i>Northwestern States Portland Cement Co. v. Minnesota</i> , 358 U.S. 450, 458, 3 L. Ed. 2d 421, 79 S. Ct. 357 (1959)	9
<i>American Trucking Ass'n. Inc. v. Scheiner</i> , 483 U.S. 266, 269, 97 L. Ed. 2d 226, 107 S. Ct. 2829 (1987)	9
<i>Complete Auto Transit, Inc. v. Brady</i> , 430 U.S. 274, reh'g den., 430 U.S. 976 (1977)	10
<i>Goldberg v. Sweet</i> , 488 U.S. 252 (1989)	10
<i>Welton v. Missouri</i> , 91 U.S. 275 (1876)	11
<i>Halliburton Oil Cementing Co. v. Reily</i> , 373 U.S. 64 (1963)	11
<i>Wyoming v. Oklahoma</i> , 502 U.S. 437 (1992)	12, 13, 14
<i>Klein v. Board of Tax Supervisors of Jefferson County</i> , 282 U.S. 19 (1930)	13
<i>Colgate v. Harvey</i> , 296 U.S. 404, 420 (1935)	13
<i>Armco v. Hardesty</i> , 467 U.S. 638, 644 (1984)	14
<i>Norfolk & Western R. Co. v. Missouri Tax Commissioner</i> , 390 U.S. 317, 325 (1968)	15
<i>Associated Industries of Missouri v. Lohman</i> , 511 U.S. ___, ___, 128 L.Ed.2d 639, 647 (1994)	15
<i>Henneford v. Silas Mason Co.</i> , 300 U.S. 577 (1937)	15-16
<i>Dunbar-Stanley Studios, Inc. v. Alabama</i> , 393 U.S. 537 (1969)	16
<i>Alaska v. Arctic Maid</i> , 366 U.S. 199 (1961)	16
<i>Chevron Oil Corp. v. Huson</i> , 404 U.S. 97 (1971) ...	19
Statutes:	
KRS 132.020(1)	2
KRS 132.190(1)	2
KRS 136.030	2, 3, 13
N.C.Gen.Stat. § 105-203	5
N.C.Gen.Stat. § 105-206	5
N.C.Gen.Stat. § 105-130.3	5
N.C.Gen.Stat. § 105-130.4	5
N.C.Gen.Stat. § 105-130.7	5
Constitutions:	
Article 1, Section 8, Clause 3, United States Constitution	8
Section 172, Kentucky Constitution	19

No. 94-1239

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1994

FULTON CORPORATION - - - - - Petitioner
v.

JANICE H. FAULKNER, Secretary of Revenue - Respondent

On Petition for a Writ of Certiorari
to the State of North Carolina

BRIEF AMICUS CURIAE OF THE COMMONWEALTH
OF KENTUCKY, REVENUE CABINET,
IN SUPPORT OF RESPONDENT

INTEREST OF THE AMICUS CURIAE

The Commonwealth of Kentucky, Revenue Cabinet [hereinafter "Revenue Cabinet"] submits this brief in support of the constitutional validity of the North Carolina intangibles tax levied on ownership of shares of corporate stock. Counsel for Petitioner and Respondent have consented to the filing of this amicus curiae brief. Their letters of consent are being filed with the Clerk of this Court contemporaneously with this brief.

The Revenue Cabinet's interest in the instant case arises from its involvement as the defendant in *St. Ledger v. Commonwealth of Kentucky*, 94-SC-875-D & 94-SC-468-DG, currently pending before the Kentucky Supreme Court. The *St. Ledger* plaintiffs contend that Kentucky's method of taxing corporate shares discriminates against interstate commerce by foreclosing tax neutral investment decisions.

Pursuant to KRS 132.020(1) Kentucky taxes non-exempt shares in all corporations at the rate of 25 cents per \$100 of value. Appendix [hereinafter App.] 1. The shares tax is not a transaction tax, but is rather an ad valorem tax imposed only on taxable shares with a Kentucky situs held on the January 1 assessment date set forth in KRS 132.190(1). App. 2.

Pursuant to KRS 136.030 Kentucky exempts from the ad valorem tax shares of stock issued by corporations which have paid ad valorem tax to Kentucky on at least 75% of their total property, wherever located, and whether real, tangible or intangible. App. 3. KRS 136.030 makes no distinction based on the state of incorporation, the location of the corporation's headquarters or its principal place of business. The only requirement for exemption pursuant to KRS 136.030 is that the corporation must have paid tax to Kentucky on at least 75% of its property, wherever situated.

The Kentucky Court of Appeals in *St. Ledger, supra*, upheld the Kentucky shares tax scheme on the basis of *Darnell*. *St. Ledger* is currently pending before the Kentucky Supreme Court. Following this court's decision in *Darnell v. Indiana*, 226 U.S. 390 (1912), upholding the exemption of domestic shares of stock while taxing foreign shares of stock as "consistent with substantial equality," there were no Commerce Clause challenges to taxes on intangible property for almost 80 years. The Kentucky legislature, like the legislatures of many other states, has

relied upon *Darnell* in drafting its shares tax statutes. Indeed, Kentucky's current scheme was enacted in 1917, only five years after *Darnell* was decided. Moreover, Kentucky courts have sanctioned its shares tax scheme under the applicable state constitutional provisions, and this Court has upheld it against an equal protection challenge. *Klein v. Jefferson County Bd. of Tax Supr's*, 230 Ky. 182, 18 S.W.2d 1009 (1929) *aff'd*, 282 U.S. 19 (1930).

It is clear from this Court's holdings in *Darnell* and *Klein* that the purpose of the statutory scheme at issue in this case, as well as Kentucky's KRS 136.030, is to achieve equity by relieving the burden of double taxation which the state property taxes would otherwise impose on in-state holders of the stock of corporations which have paid tax on their property or income within the state. *Darnell*, 226 U.S. at 398, citing *Kidd v. Alabama*, 188 U.S. 730 (1903). Kentucky, like many other states, has a policy to alleviate double taxation, a policy which was upheld in *Darnell*. Therefore, the Revenue Cabinet urges this Court to affirm the decision below of the North Carolina Supreme Court for the reasons which follow.

SUMMARY OF ARGUMENT

I. The North Carolina Supreme Court correctly ruled that the shares tax does not violate the Commerce Clause. This Commerce Clause challenge is controlled by *Darnell v. Indiana*, 226 U.S. 390 (1912), which held that the taxation of "the property of domestic corporations and the stock of foreign ones in similar cases" is "consistent with substantial equality." *Id.* at 398. As *Darnell* is still good law, and is directly on point with the case at hand, it should be held to be applicable so as to uphold the North Carolina shares tax scheme.

II. The North Carolina shares tax scheme is not facially discriminatory under Commerce Clause jurisprudence

because it does not distinguish between corporations based on whether they are domestic or foreign corporations. It thus does not involve a "direct commercial advantage to local business" not given to out-of-state business. *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981).

III. The important state interest to avoid double taxation underlies the North Carolina shares tax scheme, and any indirect burden on interstate commerce does not exceed the local benefits. The state's interest is to alleviate the burden of double taxation on the shareholders of corporations which pay income taxes to North Carolina. By allowing the owners of stock of corporations which pay income tax to North Carolina to deduct the percentage of that income tax paid from their intangible property tax bill, North Carolina properly effectuates the important and legitimate state interest of avoiding double taxation.

Moreover, the shares tax scheme does not impose a direct burden on interstate commerce. Here, no out-of-state property is banned from being imported into the state, or taxed solely because of its out-of-state origin. Additionally, neither the statutes nor their application distinguishes between in-state and out-of-state corporations. This Court has recognized that a non-discriminatory intangibles tax on corporations has only an indirect and incidental effect on interstate commerce. *Virginia v. Imperial Coal Sales Co.*, 293 U.S. 15 (1934). Thus, because the shares tax does not impose a direct burden on interstate commerce, and is justified by the legitimate state interest of avoiding double taxation, the tax should be upheld as constitutional.

IV. The North Carolina shares tax scheme is internally consistent and there is no risk of multiple taxation because no other state may constitutionally tax the same shares consistent with the requirements of the Due Process and Commerce Clauses because those shares would not have situs in those states.

V. Even if found to be facially discriminatory, the North Carolina shares tax should be upheld under the compensatory tax doctrine because it involves the reduction in the shares tax to the shareholder, is offset proportionally by way of the income tax on the corporation issuing the shares, and thus "imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce . . ." *Oregon Waste Systems, Inc. v. Dept. of Environmental Quality*, 511 U.S. ___, 128 L.Ed.2d 13, 23 (1994).

ARGUMENT

THE NORTH CAROLINA SUPREME COURT CORRECTLY RULED THAT THE TAX ON CORPORATE STOCK DOES NOT VIOLATE THE COMMERCE CLAUSE.

A. Fulton Corporation's Commerce Clause Challenge is Controlled by *Darnell v. Indiana*.

The instant case involves the North Carolina scheme of taxation of shares of stock owned by North Carolina residents. See N.C.Gen.Stat. §§ 105-203, 105-206 and N.C.Gen.Stat. §§ 105-130.3, 105-130.4, and 105-130.7. Brief for Petitioner, App. at 1a through 10a. In the decision below, the North Carolina Supreme Court set forth the manner in which the intangibles tax on stock is computed:

the greater the percentage of the issuing corporation's total income which is allocated to and taxed in this state the more dividend income from that corporation a corporate shareholder is allowed to deduct and the less intangibles tax the shareholder pays. The amount by which the intangibles tax against the shareholder is reduced, therefore, is directly related to the amount of the issuing corporation's income which is allocated to and taxed in this state. If 70% of the issuing corporation's income is allocated to North Carolina, then 70% of the dividends on that corporation's stock

are deductible by the corporate shareholder as income, the stock's value for intangibles tax purposes is reduced by 70%, and the intangibles tax thereby decreased by 70%.

Fulton Corp. v. Justus, 338 N.C. 472, 450 S.E.2d 728, 729 (N.C. 1994), *cert. granted sub nom. Fulton Corp. v. Faulkner*, 131 L.Ed.2d 554 (1995).

The Supreme Court of North Carolina correctly ruled that *Darnell v. Indiana*, 226 U.S. 390 (1912) controls the Commerce Clause challenge to the tax on shares of corporate stock. In *Darnell*, the plaintiff, a resident of Indiana, owned stock in a Tennessee corporation that paid no taxes in Indiana. *Darnell* upheld against a Commerce Clause challenge an Indiana statute which taxed the stock of out-of-state corporations, but not the stock of corporations created under Indiana law. The Indiana Supreme Court held that there was no discrimination because (1) the purposes of the law were "to require all property to contribute pro rata its share of taxes, . . . , and so far as practicable to avoid double taxation," and (2) domestic corporations whose stock was exempt were taxed upon their property in Indiana while non-exempt corporations could not be so taxed on their out-of-state property. *Darnell v. Indiana*, 174 Ind. 143, 90 N.E. 769, 774 (1910), *aff'd.*, 226 U.S. 390 (1912).

Upon review, this Court in *Darnell* rejected the contention that taxing foreign corporate shares while exempting domestic corporate shares violated the Commerce Clause, saying that the taxation of "the property of domestic corporations and the stock of foreign ones in similar cases" was "consistent with substantial equality." *Darnell v. Indiana*, 226 U.S. at 398. This Court in *Darnell* rejected the argument that the policy against double taxation does not justify the distinction made because the property of the non-domestic corporation is presumably taxed in its home state. *Id.* In so doing the *Darnell* opinion referred to *Kidd*

v. Alabama, 188 U.S. 730 (1903) and *Wright v. Louisville & N. R. Co.*, 195 U.S. 219, 222 (1904) ("A tax in another state is no tax for the purposes of the state of Georgia."). This Court in *Darnell* also rejected the argument that there was discrimination because the Indiana statutes "do not make allowance if a foreign corporation has property taxed within the state," saying that the appellants "do not show that [such a case] is theirs, and that, as they do not belong to the class for whose sake the constitutional protection be given, if it would, they cannot complain on that ground." *Id.* at 398.

The *Darnell* decision directly applies and must be followed in this case. The North Carolina tax scheme is very similar to the tax scheme at issue in *Darnell*.¹ Under the North Carolina tax scheme there is a "reduction in the shares tax to the shareholder which is offset in a direct proportional way to the corporation." *Justus*, 450 S.E.2d at 732. While it is true that *Darnell* involved a property tax on shares of stock to the shareholder which was offset by a property tax to the corporation, that distinction, as the lower court found, is immaterial.

This Court should rule that the lower court properly held that *Darnell* is applicable so as to uphold the constitutionality of the North Carolina taxing scheme. The Indiana Supreme Court recently followed *Darnell* and upheld the same statute involved in *Darnell* against the same Commerce Clause challenge raised by Fulton Corporation. *Indiana Dept. of State Revenue v. Felix*, 571 N.E.2d 287 (Ind. 1991), *cert. dismissed*, 502 U.S. 1084 (1992). The Court in *Felix* held that recent Commerce Clause decisions of this Court have not superseded *Darnell*, and that the policy against double taxation is still a sufficient basis to

¹The Kentucky shares tax scheme is even more similar to that in *Darnell*; i.e., it involves a property tax to shareholders which is directly offset by a property tax on corporations.

justify a tax offset by the tax paid by domestic corporations. *Felix*, 571 N.E. 2d at 291-92 (citing *Darnell*). This Court has stated that “[i]f a precedent of this [Supreme] Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [the lower courts] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions.” *American Trucking Assns. v. Smith*, 496 U.S. 167, 180 (1990). Moreover, this Court has recently indicated that *Darnell* is still good law, see *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. ___, 131 L.Ed.2d 261, 276-77, n.6 (1995), and as it is directly on point, it should apply here, so as to support a holding of constitutionality.

B. The North Carolina Shares Tax Scheme is Not Facially Discriminatory.

The Commerce Clause provides that “[t]he Congress shall have power . . . [to] regulate Commerce . . . among the several States.” Art. I, § 8, cl. 3. “Though phrased as a grant of regulatory power to Congress, the Clause has long been understood to have a ‘negative’ aspect that denies the States the power to unjustifiably discriminate against or burden the interstate flow of articles of commerce.” *Oregon Waste Systems v. Dept. of Environmental Quality*, 511 U.S. ___, ___, 114 S.Ct. 1345, 1349 (1994) (citations omitted).

It is well-established in the law that a taxpayer who is challenging a state tax statute under the Commerce Clause bears the burden of proving that discrimination exists. See *Norton Co. v. Dept. of Revenue*, 340 U.S. 534 (1951). Moreover, in a challenge to the facial validity of a statute, a taxpayer must show that “no set of circumstances exists under which the [a]ct would be valid. The fact that [the tax] might operate unconstitutionally under some conceivable set of circumstances is insufficient to render it wholly invalid.” *United States v. Salerno*, 481 U.S. 739, 745 (1987).

State tax discrimination has been defined as a “direct commercial advantage to local business” not given to out-of-state business. *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981). The negative aspect of the Commerce Clause thus “prohibits economic protectionism—that is regulatory measures designed to benefit in-state economic interests by burdening out-of state competitors,” *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273 (1988), (emphasis added) and prohibits the “differential tax treatment of interstate and intrastate commerce.” *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, *reh’g den.*, 453 U.S. 927 (1981). Thus, discriminatory state taxes for purposes of the Commerce Clause are those which “favor local enterprises at the expense of out-of-state businesses . . .”. *Boston Stock Exchange v. State Tax Comm’n.*, 429 U.S. 318, 328 (1977).

In the recent case of *Oklahoma Tax Comm’n. v. Jefferson Lines*, *supra* at 279-80 this Court upheld an unapportioned state sales tax on the full cost of interstate bus tickets, and restated these principles as follows:

A State may not ‘impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to a local business.’ *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458, 3 L. Ed. 2d 421, 79 S. Ct. 357 (1959); see also *American Trucking Assns. Inc. v. Scheiner*, 483 U.S. 266, 269, 97 L. Ed. 2d 226, 107 S. Ct. 2829 (1987). Thus, States are barred from discriminating against foreign enterprises competing with local businesses, see, e.g., *Scheiner*, *supra*, at 286, 97 L. Ed. 2d 226, 107 S. Ct. 2829, and from discriminating against commercial activity occurring outside the taxing State, see, e.g., *Boston Stock Exchange v. State Tax Comm’n.*, 429 U.S. 318, 50 L. Ed. 2d 514, 97 S. Ct. 599 (1977). No argument has been made that Oklahoma discriminates against out-of-state enterprises, and there is no merit

in the argument that the tax discriminates against interstate activity.

This Court's four-prong test for evaluating a challenge under the Commerce Clause is set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, *reh'g den.*, 430 U.S. 976 (1977). A state tax will be held valid with regard to a Commerce Clause challenge if: (1) the tax is applied to an activity having a substantial nexus with the taxing state; (2) the tax is fairly apportioned; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the services provided by the state. *Id.* at 277-78. The prong at issue here is the third — whether the tax discriminates against interstate commerce.

For Fulton Corporation to meet its burden of proving state tax discrimination, it must show unequal treatment of different groups of taxpayer corporations. Unequal treatment can arise either on the face of the tax statute or from the impact of a facially neutral statute. The North Carolina shares tax statutes are clearly not facially discriminatory because they do not distinguish between corporations based on the state of incorporation, place of doing business or any other basis. Indeed, all corporations qualify for the exemption from shares tax as long as they meet the statutory requirements regarding income. As a North Carolina corporation, Fulton Corporation is an "insider who presumably [is] able to complain about and change the tax through the [North Carolina] political process." *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989). Further, "[I]t is not a purpose of the Commerce Clause to protect state residents from their own taxes." *Id.*

This situation is dramatically different from that present in cases in which this Court has found statutory schemes to be facially discriminatory. For instance, in *Boston Stock Exchange v. State Tax Comm'n.*, *supra*, the challenged provisions taxed the in-state sale of stock at a lower rate than

the out-of-state sale of stock; in *Welton v. Missouri*, 91 U.S. 275 (1876) a license tax was imposed only on itinerant salesmen who sold goods produced outside the state; and in *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963), a tax statute imposed higher use taxes on out-of-state manufacturers than on in-state manufacturers.

The North Carolina shares tax does not facially discriminate against interstate activity or against out-of-state enterprises competing with local businesses. The imposition of the North Carolina shares tax is not based on the in-state versus out-of-state origin of the shares involved, or on whether the corporation participates in interstate commerce or not. Rather, it is imposed on all shares in all corporations, except for those entities which are entitled to an offset due to the amount of income tax paid to North Carolina. Further, the shares tax confers no "direct competitive advantage on local businesses," *Maryland v. Louisiana*, 451 U.S. at 754, because (1) shares of stock are not objects of competition among the corporations which issue them; and (2) the shares tax does not affect the ability of the issuing corporations to compete in in-state or interstate markets. The shares tax simply does not affect the ability of a corporation to compete in interstate commerce because the tax is paid neither by the corporation nor its customers, it does not increase the cost of the corporation's raw materials or services, it does not reduce the corporation's profit margin and it does not give competitors an advantage either in price or net profits.

Thus, because there is no distinction under the North Carolina shares tax scheme between the in-state or out-of-state origin of stock it cannot be held that the tax is a direct burden on interstate commerce. The tax cannot therefore be judged under the standard of *per se* invalidity which attaches to taxes discriminatory on their face.

C. The Important State Interest to Avoid Double Taxation Underlies the North Carolina Shares Tax Scheme, and any Indirect Burden on Interstate Commerce Does Not Exceed the Local Benefits.

Where the tax at issue has "only indirect effects on interstate commerce," the Court must first consider whether there is a legitimate state interest underlying the statute; if so, then the burden on interstate commerce must "clearly exceed the local benefits" before the taxing statute will be unconstitutional. *Wyoming v. Oklahoma*, 502 U.S. 437, 454 n. 12 (1992).

In judging a claim of Commerce Clause discrimination, this Court must review a state tax "in light of its actual effect considered in conjunction with other provisions of the State's tax scheme." *Maryland v. Louisiana*, 451 U.S. at 756. In this case, the Court must therefore consider the North Carolina shares tax as an integrated scheme which taxes both domestic and foreign corporations with a substantial nexus to North Carolina. North Carolina taxes domestic and foreign corporations on an equal basis. Both types of entities pay income tax to North Carolina based on the amount of income which they earn. There is no distinction made between domestic and foreign corporations. Shareholders in corporations which earn income in North Carolina are entitled to a reduction in the amount of property tax on those shares which is directly related to the amount of income of the issuer corporation which is taxed in the state. Thus, North Carolina's shares tax scheme does not impose a direct burden on interstate commerce.

Here, no out-of-state property is banned from being imported or taxed solely because of its out-of-state origin. Moreover, neither the statutes at issue nor their application distinguishes between in-state and out-of-state corporations. In *Virginia v. Imperial Coal Sales Co.*, *supra*, this

Court recognized that a non-discriminatory intangibles tax on corporations has only an indirect and incidental effect on interstate commerce. Because North Carolina's tax scheme regarding shares of stock has at most an indirect effect on interstate commerce, the standard set forth by this Court in *Wyoming* is applicable here.

The legitimate state interest of the State of North Carolina underlying the tax scheme of shares of stock is to alleviate double taxation. The state's interest is to alleviate the burden of double taxation on the shareholders of corporations which pay income taxes to North Carolina. By allowing the owners of stock of corporations which pay income tax to North Carolina to deduct the percentage of that income tax paid from their intangible property tax bill, North Carolina properly effectuates the important and legitimate state interest of avoiding double taxation.² It is well settled in the law that the avoidance of double taxation is a legitimate state interest. See *Klein v. Jefferson Co. Board of Tax Supervisors*, 282 U.S. 19 (1930); *Colgate v. Harvey*, 296 U.S. 404, 420 (1935).

Indeed, this Court, in *Darnell v. Indiana*, *supra*, affirmed the finding of the Indiana Supreme Court that the

²It should be pointed out that Kentucky's tax scheme involving shares of stock does not impose a direct burden on interstate commerce either. Like the North Carolina shares tax scheme, under the Kentucky scheme, no out-of-state property is banned from being imported or taxed solely because of its out-of-state origin. Moreover, the tax scheme does not distinguish among corporations depending on the state where they are incorporated, headquartered, or do business. KRS 136.030 exempts from the tax shares held in corporations, foreign or domestic, which have paid taxes to Kentucky on at least 75% of their property, wherever located. Shares of corporations formed in states other than Kentucky have qualified for the exemption, while the shares of many corporations formed in Kentucky have not.

purpose of the statute which exempted from tax stock of Indiana corporations, while taxing the stock of out-of-state corporations, was "to require all property to contribute pro rata its share of taxes, and so far as practicable to avoid double taxation." *Darnell v. State of Indiana*, 90 N.E. 769, 774 (Ind. 1910) (emphasis added). The Indiana Supreme Court recently revisited the intangibles tax issue, and once again found that the policy against double taxation justified the tax scheme:

The State, in its discretion might tax the shares of stock in [a domestic] corporation to the individual owners thereof residing in this State, but it would in a sense be double taxation, and it has not been the policy of this State to do so. Shares of stock in a foreign corporation doing business in another state, owned and held by a resident of this State, are taxed because they have not been and cannot be otherwise taxed by this State.

Felix, supra at 290 (quoting *Darnell*, 90 N.E. at 774).

The North Carolina shares tax clearly is *not* "designed to benefit in-state economic interests by burdening out-of-state competitors." *Wyoming v. Oklahoma*, 502 U.S. 437 (1992). The North Carolina shares tax scheme thus does not impose a direct burden upon interstate commerce, and is justified by the legitimate state interest of avoiding double taxation. This Court should affirm the North Carolina Supreme Court's decision holding that the tax scheme does not violate the Commerce Clause.

D. The North Carolina Shares Tax Scheme Is Internally Consistent.

Under the internal consistency test a tax "must be such that, if applied by every jurisdiction, there would be no impermissible interference with free trade." *Armco v. Hardesty*, 467 U.S. 638, 644 (1984). Here, North Carolina's shares tax system is the epitome of fair apportionment

and internal consistency. There is no risk of multiple taxation of the same property if other states adopted this system because North Carolina can only tax those shares which have a situs in the state on the assessment date. No other state may constitutionally tax the same shares consistent with the requirements of the Due Process and Commerce Clauses because those shares would not have a jurisdictional situs in those other states. *Norfolk & Western R. Co. v. Missouri Tax Commissioner*, 390 U.S. 317, 325 (1968). In *Norfolk & Western R. Co.* the Court held that "the taxation of property not located in the taxing State is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is due." *Id.* Thus, the internal consistency test is irrelevant to an ad valorem tax which is expressly limited to property with a North Carolina situs.

E. The North Carolina Shares Tax Scheme is Compensatory in Nature and Thus Should be Upheld as Constitutional.

The North Carolina Supreme Court properly held that the shares tax is a valid compensatory tax. Under the compensatory tax doctrine "a facially discriminatory tax that imposes on interstate commerce the rough equivalent of an identifiable and 'substantially similar' tax on intrastate commerce does not offend the negative Commerce Clause." *Oregon Waste Systems, Inc. v. Dept. of Environmental Quality*, 511 U.S. ___, ___, 128 L. Ed.2d 13, 23 (1994). An apparently discriminatory tax will be upheld where it is "designed simply to make interstate commerce bear a burden already borne by intrastate commerce." *Associated Industries of Missouri v. Lohman*, 511 U.S. ___, ___, 128 L. Ed.2d 639, 647 (1994).

An apparently discriminatory tax was upheld under the compensatory tax doctrine in *Henneford v. Silas Ma-*

son Co., 300 U.S. 577 (1937) which established the constitutionality of compensatory use taxes. The rationale set forth in that decision is applicable here. In *Henneford* the state of Washington imposed a use tax on property purchased outside the state on which no sales tax had been paid. The purpose of the tax was to compensate for Washington's sales tax by imposing a tax equal in amount to the sales tax that would have been imposed on the sale if it had occurred within the state. The use tax thus effectively applied only to goods purchased out-of-state or in interstate commerce, since any in-state purchase would already have been subjected to sales tax and thus would have been exempted from use tax. Despite the facial discrimination in the use tax, this Court sustained it because the "practical effect" of the overall tax structure imposed a burden on the out-of-state purchase of goods identical to that imposed on an equivalent in-state purchase. *Henneford*, 300 U.S. at 581. See also *Dunbar-Stanley Studios, Inc. v. Alabama*, 393 U.S. 537 (1969); (tax on transient photographers compensated by tax on photographers conducting business from a fixed location); *Alaska v. Arctic Maid*, 366 U.S. 199 (1961) (business license tax on freezer ships compensated by tax on local canners).

In *Artic Maid*, the Court upheld a tax on freezer ships obtaining fish for freezing, in part because local canners were subjected to even higher taxes. The Court focused on identifying the competitors of the freezer ships, which were determined to be the Alaskan canners, and not the businesses which froze fish for the local retail market. Local fish processors selling to the consumer market were subjected to a lower tax than the freezer ships, but the canners were subjected to a higher tax than the freezer ships. *Id.* at 204. The *Artic Maid* rationale thus suggests that it is crucial to assess the competitive effects in determining whether two taxes are compensatory in nature.

Similarly, in *Darnell v. Indiana*, Justice Holmes applied the compensatory tax doctrine to uphold the tax when he observed that the state's taxation of "the property of domestic corporations and the stock of foreign ones" was "consistent with substantial equality notwithstanding the technical differences." 226 U.S. at 398. Moreover, the Indiana Supreme Court clearly regarded *Darnell* as involving the application of the compensatory tax doctrine. 571 N.E.2d at 291.

Thus, as the North Carolina Supreme Court concluded, even if the shares tax scheme were determined to be discriminatory, it must be upheld as a compensatory tax. That court's analysis of the compensatory tax doctrine in relation to the North Carolina shares tax scheme was correct and should be applied by this Court:

In the instant case the state imposes an intangibles tax on the shares of stock of corporations the amount of which is directly and inversely proportional to the income of the issuing corporation which is taxed in North Carolina. The effect is to reduce the intangibles tax liability for stock held in a corporation to the extent the corporation's income is taxed in this state and to increase the intangibles tax liability on stock held in a corporation to the extent the corporation's income is not taxed in North Carolina. This is the very kind of 'compensating' tax scheme the Supreme Court upheld in *Darnell*."

Fulton Corp. v. Justus, 450 S.E. 2d at 732.

The fact that the North Carolina shares tax scheme does not involve the offset of a property tax on the shareholder against a property tax on the corporation does not prohibit the application of the compensatory tax doctrine. Moreover, there is no constitutional or equitable reason to require a state to extend the credit or exemption to taxes paid to other states because the same taxpayer has not paid both taxes. Although the state, which would other-

wise receive the benefit of the double taxation, may choose to allow a credit or exemption even where the taxes creating the double taxation problem are paid to it by different taxpayers (the corporation and its equity owners), it is not constitutionally compelled to extend that same treatment to taxes of which it has not received the benefit. Thus, when the third party taxpayer (the issuer corporation) has paid the taxes to a second state, the taxing state may properly recognize the difference in taxpayers and decline to treat the situation as the same sort of double taxation in which it has received taxes on both forms of wealth.

This Court should reject Petitioner's call for abandonment of the less restrictive compensatory tax theory created by *Darnell* for ad valorem taxation of shares of stock. State ad valorem taxes on shares of stock should not be required to meet the strict standards for compensatory taxes which have been established for other taxes. Such taxes do not present the same double taxation inequities inherent in taxation of shares of stock. Shares of stock, by their nature, are representative of value which derives from other sources which may themselves have already been taxed. Where a state's own tax laws create such an inequity as double taxation, that state should be free to alleviate it on a non-discriminatory basis by making the same exemption available to holders of stock of corporations without regard to state of incorporation, and without being required, as a price for pursuing fairer tax laws, to alleviate inequities of which it has not received a benefit and which are not of its own making but rather are caused by the tax laws of other states.

Fulton Corporation's argument would render illegitimate the purpose of North Carolina, Kentucky and other states to achieve greater tax equity in their shares tax schemes. If Fulton Corporation's argument were accepted by the Court, it would force the taxing state to choose

between an unfair taxing scheme encompassing double taxation or to forego entirely this revenue source in favor of an even more unfair tax scheme which arbitrarily allows owners of corporate shares to escape the ad valorem taxes by which holders of all other forms of wealth are required to support the common government.

If the shares tax schemes in place in many states were stricken as violative of the Commerce Clause, the ability of state legislatures to fashion equitable systems of property taxation as mandated by state constitutions would be crippled.³ Fulton Corporation's argument should not be accepted because it is based on an interpretation of this Court's Commerce Clause jurisprudence, which is unwarranted and which would produce inequitable results. States have for decades justifiably relied on this Court's decisions in *Darnell* and *Klein* in enacting these tax schemes. Because the instant case "involves a reduction in the shares tax to the shareholder which is offset in a direct proportional way by an income tax to the corporation," *Justus*, 450 S.E.2d at 732, the compensatory tax doctrine should be applied by this Court to uphold the North Carolina shares tax scheme.

Moreover, any change in the law involving the abandonment of the rule of *Darnell* should not be applied retroactively, either to the parties before this Court or to other entities, such as the Commonwealth of Kentucky, which might be affected by such a ruling. *Chevron Oil Corp. v. Huson*, 404 U.S. 97 (1971); *American Trucking Assns. v. Smith*, *supra*.

³For example, Ky.Const. § 172 mandates that:

"All property, not exempted from taxation by this Constitution, shall be assessed for taxation at its fair cash value, estimated at the price it would bring at a fair voluntary sale..."

CONCLUSION

For all of the foregoing reasons, the judgment of the North Carolina Supreme Court should be affirmed.

Respectfully submitted,

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APPENDIX

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1. KRS 132.020(1)

An annual ad valorem tax for state purposes of thirty-one and one-half cents (\$0.315) upon each one hundred dollars (\$100) of value of all real property directed to be assessed for taxation, and one and one-half cents (\$0.015) upon each one hundred dollars (\$100) of value of all privately-owned leasehold interests in industrial buildings, as defined under KRS 103.200, owned and financed by a tax-exempt governmental unit, or tax-exempt statutory authority under the provisions of KRS Chapter 103 directed to be assessed for taxation, except that the rate shall not apply to the proportion of value of the leasehold interest created through any private financing, and one and one-half cents (\$0.015) upon each one hundred dollars (\$100) of value of all tobacco directed to be assessed for taxation, and *twenty-five cents (\$0.25) upon each one hundred dollars (\$100) of value of all money in hand, shares of stock, notes, bonds, accounts, and other credits, whether secured by mortgage, pledge, or otherwise, or unsecured*, except as otherwise provided in subsection (2) of this section, and one and one-half cents (\$0.015) upon each one hundred dollars (\$100) of value of unmanufactured agricultural products, one-tenth of one cent (\$0.001) upon each one hundred dollars (\$100) of value of all farm implements and farm machinery owned by or leased to a person actually engaged in farming and used in his farm operations, one-tenth of one cent (\$0.001) upon each one hundred dollars (\$100) of value of all livestock and domestic fowl, one-tenth of one cent (\$0.001) upon each one hundred dollars (\$100) of value of all tangible personal property located in a foreign trade zone as designated under 19 U.S.C. Sec. 81, fifteen cents (\$0.15) upon machinery of individuals or corporations actually engaged in manufacturing, fifteen cents (\$0.15) upon commercial radio, television and telephonic equipment directly used or associated with electronic equipment

which broadcasts electronic signals to an antenna, fifteen cents (\$0.15) upon property which has been certified as a pollution control facility as defined in KRS 224.01-300, one-tenth of one cent (\$0.001) upon property which has been certified as an alcohol production facility as defined in KRS 247.910, or as a fluidized bed energy production facility as defined in KRS 211.390, twenty-five cents (\$0.25) upon each one hundred dollars (\$100) of value of motor vehicles qualifying for permanent registration as historic motor vehicles under the provisions of KRS 186.043, and forty-five cents (\$0.45) upon each one hundred dollars (\$100) of value of all other property directed to be assessed for taxation shall be paid by the owner or person assessed except as provided in subsection (2) of this section and KRS 132.030, 132.050, 132.200, 136.270, 136.300, 136.320, and other sections providing a different tax rate for particular property. (emphasis added)

2. KRS 132.190(1)

The property subject to taxation, unless exempted by the Constitution, shall be as follows:

- (a) All real and personal property within this state, including intangible personal property of nonresidents and corporations not organized under the laws of this state that has acquired a business situs within this state, except that twenty-five (25) domestic fowl to each family shall be exempt from taxation for any purpose.
- (b) All intangible personal property of individuals residing in this state and of corporations organized under the laws of this state unless it has acquired a business situs without this state.

3. KRS 136.030(1)

The individual stockholders of a corporation shall not be required to list their shares for ad valorem taxation

so long as the corporation pays taxes to the State of Kentucky on at least seventy-five percent (75%) of its total property, wherever located. Bonds and obligations of the United States of America and its possessions and bonds and obligations of the State of Kentucky, its instrumentalities, and its political subdivisions and their instrumentalities shall not be considered in the computation of the total property of the corporation, wherever located, nor in the computation of the amount of property upon which the corporation pays ad valorem taxes to the State of Kentucky. In order to obtain this exemption, the stockholder shall furnish satisfactory proof to the Revenue Cabinet that at least seventy-five percent (75%) of the total property of the corporation as hereinabove specified is taxed in the State of Kentucky.